THE NOTE-ISSUE PROVISIONS OF THE OWEN-GLASS BILL[1]

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On the 28th of September, 1840, Daniel Webster came to New York city and made a speech "On the Currency" before "The Merchants Meeting" in Wall Street. When I first read his address, I was impressed not only by its wisdom and intimate knowledge of the subject, but also by the fact that much of what he said would be pertinent and appropriate if it were delivered to-day. Here, for instance, are his words with regard to banking control, which would apply to the conditions of 1913 just as they did to those of 1840:

> In discounting notes in its own bills, a bank adds to the circulation of the country. In the absence of all government control and supervision, the wisdom and discretion regulating the amount of money afloat at any time is but the aggregate wisdom and discretion of all the banks collectively considered, each individual bank acting from the prompting of its own interests without concert with others, and not from any sense of public duty. In my judgment such a regulator, or such a mode of regulating the currency and deciding what should be the amount of money in the community, is unsafe and untrustworthy, and is one to which we can never look to guard us against those excessive expansions and contractions which have been the source of such injurious consequences.

Webster believed in a central bank and in its control by the government, and some of you, I am sure, will agree with me that Webster was right. None of us have had the opportunity to watch the operations of such a bank, yet many of us are convinced that the Second Bank of the United States, which was a mighty regulator of the currency, would have endured

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to the present day if from the beginning it had been under government control. That the coinage of money—the most important commodity in the world, used by every citizen in his daily affairs—should not be left to competition, but should be the exclusive privilege of the government, has long been conceded. It follows logically, therefore, that any issue of bank credit in the form of bank notes, since these are universally accepted by the people as the equivalent of money, should, like the coinage of money, be performed either by a government institution or under conditions over which the government has absolute control.

I am in sympathy, therefore, with the underlying intent of the Owen-Glass bill, namely, that bank notes in this country shall be supported by government credit, just as bank notes are in Germany, France and many other countries; and for six months I have been hoping that the framers of this bill would finally draft a workable measure to accomplish this purpose. To-day, with great reluctance, I must state my conviction that they have failed. The Owen-Glass bill creates an entirely new kind of banking machine. Nothing like it has ever been tested by this or any other country. In many of its details it resembles established banking institutions, but in its essentials, in its anatomy so to speak, it resembles no bank with which the world has had experience. If by mandate of Congress it were put into operation, I believe that within two or three years it would bring this country into a period of credit expansion that would terminate in panic and the utter collapse of our banking system.

The reasons which have led me to this pessimistic verdict, so far as they relate to the issue of notes, may be grouped under three heads: First, the bill will lead to a confusion of money with bank credits. Second, it provides for an incompetent and inadequate control. Third, there will be fatal division of responsibility.

I assume that you are familiar with the framework of the Owen-Glass bill, and with the conditions under which notes are to be issued. They are the obligation of the United States; receivable for all public dues; redeemable at all the regional

banks and at the United States treasury, in which a five-per-cent gold redemption fund must be maintained; protected by a gold and lawful-money reserve of thirty-three and one-third per cent; taxed at the discretion of the central board at the rate of at least one-half of one per cent per annum; protected by a deposit of short-time commercial paper. The notes must bear a distinctive letter and serial number, showing through which federal bank they were issued, and no federal reserve bank under a penalty of ten per cent shall pay out the notes of any other bank, it being expected that such notes will be sent home or to Washington for redemption. All these things are details that have no effect whatever upon my argument.

To avoid cacophonous repetition of the words "federal reserve banks," I shall speak of the federal reserve banks as the regional or sectional banks.

Although it is exceedingly difficult to foresee what will happen under hypothetical conditions, we must nevertheless make the attempt. I shall first discuss the conditions under which the sectional banks would issue notes and acquire a mass of commercial paper. A new issue of notes, it seems to me, may be at the instance either of a member bank or of the sectional bank itself, for a member bank may wish to obtain more currency through the discounting of some of its short-time paper, or the sectional bank itself may wish to increase its supply of notes in order to be able to meet the demands of its depositors drawing upon their balances. Thus it will prevent the reduction of its gold and lawful-money reserve.

Second, a sectional bank will obtain its supply of commercial paper from member banks as the result of two separate circumstances: first, because the discounting bank wishes a larger supply of currency; or second, because the discounting bank wishes to increase its reserve balance with the sectional bank.

Either operation, it should be noted, unless the sectional bank already has on hand a sufficient supply of federal reserve notes, will result in the increase of its required reserve by one-third the amount of the paper discounted.

Let us see how the system will operate. Every bank will pay out federal reserve notes, if it has any, in preference to

paying out lawful money, whether over the counter or through the clearing house; for thus it will protect its reserve of gold and lawful money. For the same reason every bank will add to its reserve all the gold certificates and other lawful money which come to it over the counter or through the clearing house. Only in this way can the sectional banks increase their power to rediscount or to issue more notes. The inevitable result will be that lawful money will be drawn out of circulation into bank reserves, its place in the circulation being taken by the federal reserve bank notes—a twentieth-century illustration of Gresham's law.

This result will lead to inflation in one of two ways. First, the banks will lend more freely in their respective districts, causing local or regional inflation; or second, the banks will send idle money to New York to be loaned in Wall Street, thus stimulating speculative prices.

In either case, the foreign exchanges will be adversely affected, and gold will be exported. The gold exporting houses—which are now located in New York city and will continue to be located there, for that city will be the greatest foreign exchange market—will obtain gold for export, not from those regional banks whose issues have been excessive, but by the presentation of federal reserve notes, or greenbacks, or gold certificates, or all three, at the federal reserve bank in New York city or at the national treasury in Washington. In other words, the banks that have been guilty of over-expansion and overissue will not pay the penalty, or be held responsible. On the contrary, since the inflation will almost certainly cause speculative excitement in the market for securities, we may confidently predict that all the mischief will be blamed on Wall Street and its bankers. This bill will certainly not put a coat of white paint on Wall Street.

Inasmuch as there is now in circulation, in use as pocket and till money, at least $500,000,000 of lawful paper money in denominations ranging from ten dollars to one hundred dollars, it is quite conceivable that the federal reserve banks may get into permanent circulation an amount of notes equal to this sum, and at the same time increase their reserves and

the reserves of member banks by an equal amount. Thus we have to face a possible, if not probable, credit expansion of some $2,000,000,000 and that would be enough to drive all our gold out of the country.

The friends of the bill apparently believe that an overissue of notes is impossible provided the security is short-time commercial paper. They argue that the notes will not remain long in circulation, because they must be retired upon the maturity of the paper deposited as security. This is evidently a mistaken view. The bill itself provides for the easy substitution of other securities in the place of those originally deposited, and such provision is absolutely necessary; for otherwise the expansion and contraction of the medium of exchange would be subject to arbitrary circumstances having no connection whatever with the need for currency.

If this country, like Canada or France, had no other form of paper money in circulation than bank notes, and if adequate facilities for daily redemption were provided, it would then be quite true that bank notes issued against commercial paper would expand and contract in response to the needs of business.

Let us next examine the forces which must be depended upon to counteract inflation. I find but one, namely, the Federal Reserve Board—seven men in Washington who are not bankers. How are they going to know whether or not inflation is anywhere in process? They are not bankers, and are not in the banking business. They take no deposits, they make no loans. They do not even redeem the notes the issue of which they authorize. They are not in daily contact with business men. They know nothing at first-hand about the needs of business. They are not able to judge when an apparently prosperous industry is verging on the precipice of over-production, or to distinguish between the red blood of health in trade and the hectic flush and excitement which forebode collapse. Indeed, if the bill permitted the President to put on the board the seven best bankers in the country, I doubt if they would dare assume the responsibility, for their own experience would convince them that they could not at long distance wisely regulate the operations of twelve big,

competing banks in different sections of this great country, each section supremely confident in its own resources and clamorous for all possible aid from the national institution.

The board, to be sure, has the power to examine into the affairs of the federal reserve banks, and is required to obtain and publish once a week a statement of their separate and combined assets and liabilities. Unhappily, wise bank management cannot be predicated upon statistics. A bank president must be in daily touch with his subordinates, and must aid them with his judgment when they are in doubt. The bank statement is a mere bookkeeping record of what has been done, and contains not the slightest hint as to the real character or significance of the transactions recorded.

It is evident that the central board must rely on the information it gets from the federal reserve agent. This officer, it seems to me, is the most important one provided for in the whole system. He is the man who must pass on applications for the issue of notes, and he must judge the quality of the paper offered as security. But this man will know nothing about conditions prevailing in other sections or districts, or about the imperative needs of other sectional banks. Naturally he will be most impressed by the dominant sentiment of his own environment, and will be inclined to do his utmost for the people with whom he is in daily contact. Yet he is the man upon whom the central board must rely for information. How can they learn from him when a regional bank is overissuing? They will not see the results or feel them; neither will the federal reserve agent nor the managers of the offending regional bank. Finance has wireless avenues of transmission and communication. Fire and earthquake in San Francisco may cause the rate of interest to rise in Shanghai. If an embarrassing demand for gold for export arises, how will the central board know which regional banks are responsible for the inflation? Will they not in their despair of understanding the situation, but knowing that inflation exists somewhere, order an advance of the rate of discount in all sectional banks, and so cause undeserved contraction and distress in many quarters?

We cannot get a clear idea of the way in which the new system would probably work unless we consider just how this central board and the federal reserve notes would be regarded in different sections of the country. We know that in some quarters there is always an unsatisfied demand for capital. Many country bankers feel that they could lend safely much more money than is deposited with them. In prosperous times there is sharp competition between sections to get possession of idle funds in the East. The great difficulty has been the lack of avenues for credit transmission. This has been due to the local character of our banks and to the prohibition of branch banking. No matter what the commercial needs of the West and South, no matter how good the local credit of merchants, nor how sound their paper, eastern banks have been and still are unable to be of much service to the West and South. One of the strongest arguments for the establishment of these federal reserve banks is undoubtedly found in the expectation that they will be able through the rediscounting process to bring about a more equal distribution of the loanable funds of commercial bankers.

But we must not forget that the sectional sentiment in this country is exceedingly strong. We are all proud of being citizens of the United States, yet the average American takes greatest pride in the section where he has his home, his friends and his business interests. Cities and sections are advertising their advantages and their prospects in order to attract both population and capital. This is all friendly competition, but it is none the less real competition.

The Owen-Glass bill sets up in each of these sections a practically autonomous banking institution, managed by citizens of the section and having the power to get money from Washington in exchange for the indorsed promissory notes of local merchants. Financially speaking, this bill incorporates the different sections of this country. To the people and to the bankers of these sections, the central board at Washington will loom up brightly as a golden pyramid. It seems to me inevitable that the local boards of the regional banks will be under constant and tremendous pressure to obtain all the

" money " possible from Washington; and the members of each board, being themselves citizens of the section, will be inclined to share in the general optimism. So the chances are that the central board will receive urgent applications for the issue of notes in excessive quantities, and, as I have already pointed out, they will not be in a position clearly to determine when the issues pass beyond the limits of prudence. Such excessive issues, since they will become a permanent part of the circulation, displacing various forms of lawful money, will not have the natural effect of reducing bank reserves. On the contrary, bank reserves will be increased, and the country will have every appearance of unbounded prosperity, as is always the case on the eve of panic.

It is morally certain that from several of the twelve districts there will come a steady and insistent demand for more " advances." The hunger for money will spring eternal in the regional stomach, and to the people of the United States the federal reserve board will seem to be an inexhaustible well of real money, in duty bound to " gush " whenever the right kind of collateral security is presented.

I am well aware that the advocates of this bill maintain that it contains all the excellent features of the great banking systems of other countries. I cannot in a few minutes point out the weakness of this contention, but I beg you to compare the control for which this bill makes provision with that which now exists in the banking systems of Canada, France and Germany. Canada, for example, has twenty-seven banks, of which twelve are exceedingly strong; but no one of these banks is sectional in character. Each is national—its operations extending over the entire dominion. The managing officers of a Canadian bank pay immediately the penalty for any error of judgment. If they overissue or overlend, the unerring dial of the clearing house gives them instantaneous warning. As a result, they practise infinite caution, for they know the perils in their path. All the men at the helm have had lifelong experience in the delicate, intricate and difficult business of banking.

In Germany and France, where the central banks are under government control, the same conditions prevail. The policies

of the two great banks of those countries are directed by men who have had training as bankers, and who feel that they must at all hazards protect the national credit and keep their institutions safe from disaster. In all countries where banking is centralized the mighty stimulus of self-interest is enlisted for the preservation of banking credit, and the bank managers have plenary powers of control and regulation. They are in the closest possible touch with the details of management, and humanly speaking, are in the best possible position to check inflation and over-expansion.

What, then, is the fundamental defect of the Owen-Glass bill, the removal of which will make it a safe and workable measure? If I have clearly expressed myself, I believe you will agree with me as to the truth of the following proposition. A safe and elastic bank currency is impossible in a country in which lawful paper money is in circulation, of the same denominations as the bank notes, unless the issuing institution is responsible for the redemption of both the lawful paper money and the bank notes.

If you grant the truth of that proposition, then you must admit that some single institution must be created which shall be required to redeem on demand not only its own bank notes, but also all other forms of paper money including gold and silver certificates. That being true, it follows necessarily that this institution must be controlled absolutely by the government of the United States, for it must take over into its vaults all the gold now held by the government in its various redemption funds. The Owen-Glass bill would add one more kind of paper money to our kaleidoscopic media of exchange; whereas, the establishment of the institution which I believe the situation calls for would put all forms of credit money on an equal footing, would make them all the liabilities of a bank controlled by the government, and would eventually give us only one kind of paper money, namely, the notes of the great and unbreakable Bank of the United States.

In conclusion, let me quote from a man who solved financial problems with a surer touch than even Daniel Webster. In 1790 Alexander Hamilton, then only thirty-three years old,

submitted an immortal document to the Congress of the United States, in which he recommended the creation of a national bank. Realizing that self-interest had been throughout the ages the mainspring of human progress, he wrote as follows:

> The keen, steady, and as it were, magnetic sense of their own interests as proprietors, in the directors of a bank—pointing invariably to its true pole, the prosperity of the institution,—is the only security that can always be relied upon for a careful and prudent administration. It is, therefore, the only basis on which an enlightened, unqualified, and permanent confidence can be expected to be erected and maintained.

Hamilton's thought was fundamentally sound, but he erred in its practical realization, for he planned a government bank, and then left its control in the hands of private citizens. Experience has taught us what we now need, namely, a national bank in which private citizens shall have a moneyed interest, and in the operation of which they shall have some voice, while over its conduct the government shall be dominant.